

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

74-2582
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ROSALIND FOGEL, et ano.,

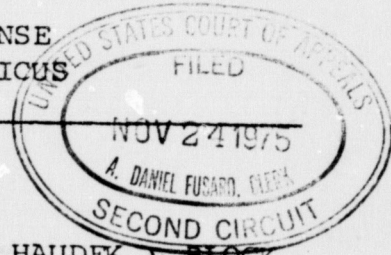
Plaintiffs-Appellants,

versus

GEORGE A. CHESTNUTT, JR., et al.,

Defendants-Appellees.

PLAINTIFFS-APPELLANTS' RESPONSE
TO THE REPLY BRIEF OF THE AMICUS



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UNITED STATES COURT OF APPEALS
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Docket No. 74-2582

ROSALIND FOGEL, et ano.,

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GEORGE A. CHESTNUTT, JR., et al.,

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PLAINTIFFS-APPELLANTS' RESPONSE
TO THE REPLY BRIEF OF THE AMICUS

Plaintiffs submit this brief in response to the Reply Brief of the Amicus dated October 29, 1975.* We confine our discussion to the legality of recapture; other subjects are covered by our previous briefs.

1. The Amicus now concedes that the stock exchange regulations permitted recapture by a mutual fund having a "bona fide broker" as investment adviser; admittedly, such a broker could apply the fund's portfolio commissions against its advisory fees (ABr 1).** The Amicus contends, however, that recapture was

*As used herein, "ABr" means the Amicus's Reply Brief, "PBr" means plaintiffs' brief of October 6, 1975.

**By sponsoring the Amicus brief without qualification, defendants have adopted this concession.

not available to a mutual fund receiving advice from an "independent non-broker Adviser" (ABr 3-4).

Nothing in the anti-rebate rules of the PBW and Pacific Exchanges supports a distinction between "bona fide brokers" (whatever that means) and other brokers. The anti-rebate rules applied to all Exchange members alike. If it was proper for one kind of member to enable its customers to recapture (by crediting portfolio commissions against advisory fees), it was equally proper for all. And it made no difference, in this context, whether the broker itself, or an affiliate of the broker, acted as investment adviser; see the SEC's Institutional Investor Study Report ("Study Report" hereinafter), quoted at PBr 6-7.

Equally meaningless is the Amicus's category of "independent non-broker Adviser". The Amicus does not define the term. Presumably it is intended to apply to a fund adviser such as the Management Co.* As we have repeatedly stated, the Management Co. could and should have organized a subsidiary with regional exchange and NASD membership; the subsidiary, performing the same functions previously undertaken by the Management Co., could have acted as introducing broker for the Fund and could have collected

*In our view, previously discussed, the Management Co. had all the characteristics of a broker necessary for NASD membership.

part of the Fund's portfolio commissions; the Fund's advisory fees could then have been reduced by the amount of those commissions. The Amicus's contention that such reduction would have been unlawful rests on nothing better than its ipse dixit. On the hypothesis stated, the Management Co. would have been affiliated with a broker; it is, therefore, a contradiction in terms to call it a "non-broker".

Nor is the "independence" of the adviser of any significance under the anti-rebate rules. The Amicus seems to contend that recapture was lawful if a broker was parent of the adviser, but unlawful if the adviser (called "independent") was parent of a broker. The anti-rebate rules lend no support to such a will-o'-the-wisp distinction. Both the PBW and the Pacific Exchanges permitted a parent-adviser's fees to be reduced by the subsidiary-broker's commissions (51a-53a, 224a-225a). The SEC, likewise, saw no difference whether recapture was effected through "[i]nvestment adviser affiliates established by broker-dealers" or through "[b]roker-dealer affiliates established by investment advisers" (see the SEC's Study Report, quoted at PBr 6-7). The Amicus's distinction "between broker's advice and independent advice" (ABr 4) is thus without substance.

2. The Amicus contends that "a broker's paying the Fund's bill from the independent non-broker Adviser" would be no less unlawful than a broker's paying the Fund's electric bills or

accountants' fees (ABr 3). The analogy is far off the mark. Neither the electric company nor the accountants are affiliated with the broker. More important, the stock exchange minimum commissions were designed to pay for the rendition of investment advice (PBr 3); they were not designed to pay for electric current or accounting services. Finally, recapture did not involve a broker's paying the bills of the investment adviser. The adviser's brokerage subsidiary would simply collect part of the Fund's portfolio commissions; thereupon, and without any further payment, the adviser would allow a corresponding reduction of its fees.

3. For no apparent reason, the Amicus discusses certain rules of the New York Stock Exchange (ABr 4). Since plaintiffs do not contend that NYSE membership would have been available to a subsidiary of the Management Co., these rules are beside the point.*

4. The Amicus's attempted distinction (ABr 4-5) of Provident Management Corp., 44 S.E.C. 442, '70-'71 CCH Fed. Sec. L. Rep. ¶ 77,937 (1970), misses the point. In that case, the adviser

*We note, therefore, only in passing that NYSE Rule 2440A did permit a NYSE broker to reduce his advisory fees by the amount of its customer's commissions. See the SEC's Institutional Investor Study Report, 92d Cong., 1st Sess., House Doc. 92-64 (1971), vol. 4, pp. 2296-7, n. 87, and accompanying text. The Amicus's contrary interpretation of the Rule (ABr 4) is in conflict with its concession that stock exchange brokers could reduce or eliminate their advisory fees in exchange for brokerage business (ABr 1).

of a mutual fund collected commissions generated by the fund's portfolio transactions. The SEC required the adviser to surrender the commissions to the fund. The SEC would not have permitted, let alone required, this recapture if it had considered it an illegal rebate.

5. The Amicus argues (ABr 2) that the adviser's affiliation with a broker might have created a conflict of interests: The adviser might have been tempted to churn the fund's portfolio transactions and to avoid best execution in the third market in order to maximize the commissions of the affiliated broker. Obviously, however, no such danger could arise if the adviser's affiliate was an introducing broker, whose commissions were recaptured by the fund through credits against advisory fees. The adviser had no interest in maximizing commissions that were bound to go back to the fund.

On the contrary, it was the Management Co.'s refusal to recapture that created a conflict of interests. It was to the Management Co.'s advantage to stimulate the sale of Fund shares by awarding give-ups and reciprocals to the share-selling dealers. The availability of give-ups and reciprocals depended on the volume of the Fund's portfolio business; it was, therefore, to the Management Co.'s interest to maximize the Fund's commissions (through

churning and similar devices) in order to make more give-ups and reciprocals available. Recapture would have eliminated the Management Co.'s interest in practices of this sort.*

CONCLUSION

The decision below should be reversed, defendants should be found liable, and the case should be remanded for determination of the amount of recovery.

Dated: November 13, 1975.

Respectfully submitted,

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*In Moses v. Burgin, 445 F. 2d 369, 375 (1st Cir.), cert. denied, 404 U.S. 994 (1971), the First Circuit noted "the general risks attendant upon a brokerage operation, especially the risk of loss of best execution", and added that the plaintiff, if willing to accept those risks, "could have chosen a fund that did have an affiliated broker" (see ABr 3). Plainly, these remarks did not contemplate an introducing broker, which would not have been subject to any of the risks referred to. In the present case, the possibility of organizing and using an introducing broker was never considered by the directors and was never called to the attention of plaintiffs and the other stockholders of the Fund.

